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National City Monthly Letter on Business and Economic Conditions

1954

New York, January, 1954

50th Anniversary

THIS issue of our Monthly Letter inaugurates its 50th year of uninterrupted publication. In January 1904 this Bank began putting out a four-page monthly circular entitled "United States Securities and Government Finance", devoted mainly, as the title indicated, to government bonds and matters pertaining thereto.

In those days the federal budget amounted to $584 million. Government bonds outstanding were approximately $900 million, consisting of five issues representing debt arising out of the Spanish-American War and coin redemption of "greenback" fiat currency issued during the Civil War. In 1902 Congress had authorized the issuance of Panama Canal 2 per cent bonds for canal construction and fortification but the first offering did not come until 1906. The market for government bonds lay principally with the banks, which were empowered to use them as security for public deposits and for national bank notes. Thus conditions in the market were governed largely by the trend of public deposits and the varying profitability to the national banks of issuing national bank currency. The Letter of the National City Bank, though confined at that time to government securities, was the first of the bank reviews published in this country and, so far as we know, anywhere in the world.

Broadening of the scope of the Bank Letter to its present character began with the outbreak of World War I in the summer of 1914. The impact of that tremendous event appeared to call for enlargement of the Letter to embody discussion of general economic and financial affairs then engaging men's minds with new urgency. Accordingly, George E. Roberts, Director of the U.S. Mint and a lifelong student of economic and monetary questions, was invited to come with the Bank as editor of the Letter. It was under his editorship, lasting until his retirement in 1940, that the Letter became established in the form familiar to our readers today.

In this publication our purpose has been to provide, to the best of our ability, an analysis of and commentary on economic and social trends for the benefit of our staff and customers and others who may be interested; and in so doing to exert what we conceive to be a constructive influence on the formulation of economic ideas and development of public policies.

The first issue, in January 1904, bore the inscription, "Those desiring this circular sent to them regularly will receive it without charge upon application." The Letter now goes to over 220,000 customers and general public readers, both in this country and abroad, including bankers, businessmen, members of Congress and other public officials, teachers and students. It is published also in Spanish and Portuguese editions. Our continued policy has been to add to the mailing list the name of any person who wants the Letter enough to ask for it.

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General Business Conditions

The year just closed has been the most prosperous in the nation's history, judged by the number of people gainfully employed, incomes received, and total output of goods and services. Most prices, except those of farm products, have been extraordinarily stable. Higher output at stable prices signifies a rise in living standards, and although a sizable share of the national product has necessarily been for defense, the volume of goods and services available for everyday living and for additions to the country's wealth has been the greatest on record. The immense and growing productive power of the country again has been impressively demonstrated.

Despite this enviable record in 1953, the year ends on a note of uncertainty with respect to business conditions. In the past few months there has been a moderate slackening in activity which is reflected statistically in the decline in manufacturers' new and unfilled orders, in less favorable retail sales figures, in the small rise in unemployment in November, and in the slow easing of industrial production. When even a moderate decline appears there is always some apprehension as to how far it may go and how long it may last. Offsetting these statistical soft spots, on the other hand, are numerous factors of strength: the favorable showing in construction contract awards, the substantial plans for new plant and equipment installations, some adjustment of inventory positions, the stable nature of government demands, the large liquid asset holdings of individuals, the availability of credit, and well-sustained personal incomes.

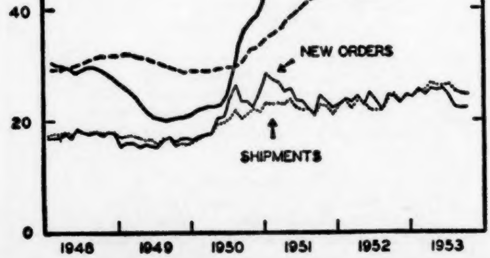
A reasonable expectation is that industrial production will hold well in the early months of 1954 as automobile output picks up and the construction and capital goods industries fill what is still a good-sized demand for their products. Construction contract awards have been running ahead of a year ago during the autumn and in November showed a 12 per cent increase. Housing contracts were down slightly but other construction awards, particularly commercial building, showed large increases. Outlays for new plant and equipment in the first quarter of 1954 are expected to be larger than in the first quarter of last year, according to the Securities and Exchange Commission. Although these outlays may later fall somewhat behind the record expenditures of 1953, they still are expected to be large compared to any other year.

Influences Affecting 1954

Construction and investment in capital goods provide formidable support for the economy, and it is seldom that total business activity has dropped off sharply when these two important segments have remained steady. Adding the demands of federal, state and local governments, which in the aggregate will probably show only minor change from 1953 levels, a good foundation for another busy year seems to exist.

Business sentiment recognizes these supporting elements. It does not expect, however, that they can fully sustain activity, and is not certain that present indications with respect to construction and capital goods programs will be fully realized. The fear is that these programs may be undermined by a drop in the flow of orders, resulting from cutbacks in inventory or from declines in consumer demand, all leading to reduced operations, lower profit expectations, and less willingness to make new investments.

Retail trade, although at a very high level, has been slowing down. During the first eight months of 1953, retail sales were 6 per cent higher than in the same period of 1952. In more recent months they have dropped, on a seasonally adjusted basis, somewhat below the earlier months, and have averaged only about 2 per cent higher than in 1952. What happened is that personal income ceased to increase as it had done in the earlier part of the year, and new consumer borrowing also slackened. The result was a slower rise in sales. This slowing down carried into the Christmas season, when retail sales appear to



Manufacturers' New Orders, Unfilled Orders, Shipments, and Inventories, by Months.

have held abreast of last year but were unable to show gains.

The inventory rise also has plainly flattened out, at least to the extent that it represented voluntary accumulation. The inducement to add to inventories or to place commitments for materials or goods far ahead has weakened as the year advanced and the immense output of goods brought back quick deliveries and buyers' markets.

Retail sluggishness and the flattening of the inventory rise have had repercussions upon manufacturers, as can be seen from the accompanying chart. New orders have slackened. Shipments are exceeding new orders, a situation which obviously cannot last indefinitely. However, the fall in orders and backlogs is partly due to curtailment in military buying.

Fear of a Downward Spiral

The principal question for 1954 is whether falling orders, starting with even modest inventory adjustments and modest declines in various categories of demand, will spiral into reduced employment, falling purchasing power, and curtailment feeding on itself. The Australian economist, Colin Clark, has become the spokesman of an extreme pessimistic view. In recent issues of the Manchester (England) Guardian Weekly, he has published two articles entitled "Danger Signs Of An American Slump", in the course of which he describes the spiraling effect as follows:

> When one business cuts back its inventories another business (or rather group of businesses) must find its current sales reduced by exactly this same amount. This is an inescapable arithmetical conclusion . . .
>
> Once everybody is engaged on cutting back inventory because his sales have fallen, because somebody else has cut back inventory because his sales have fallen . . . we are involved in a process which goes on and on of its own accord until the economy has fallen to an extremely low level.

The first impression that this statement will make upon most American business men is that its conclusion implies an inevitability that does not accord with observation and experience. It is true that inventory reduction produces spiraling tendencies, and inventory changes have long been recognized as one of the most powerful causes of business fluctuations. Whether the spiral will go "on and on of its own accord", however, until an extremely low level has been reached, is another question. Obviously it always stops at some level, and the influences which will determine the stopping point vary greatly at different times.

Mr. Clark recognizes that the downward spiral may be halted or prevented from starting by such factors — drawing on the experience of recent years — as expanding export demand or government expenditures, reduced taxes, latent demand for construction and producers' goods hitherto unsatisfied, or easier money. But he expects contraction instead of expansion in export, government, and capital goods demands, and considers it improbable that prospective tax reductions and easier money will suffice to prevent the spiral from carrying business very far down during 1954.

Even at this point most observers of the American business situation will part company with his conclusions. They expect only small declines in exports, in government expenditures, in construction and in the producers' goods industries; and they reject the opinion that calamitous consequences can flow from such small causes. They believe that reduced taxes will help maintain and probably stimulate consumer buying, particularly in view of the immense liquid assets which fortify the financial position of individuals. Perhaps even more important, they believe that an abundance of capital and credit will be available for sound and worthy business projects, which may encourage people to go ahead with investment programs, and in any event will keep the situation free from money pressure and forced liquidation.

When a downward spiral such as Mr. Clark fears has developed in the past it has usually been preceded by active speculation in securities, commodities, real estate, or whatever people may have turned to at the time; and by excessive credit expansion for these speculative uses. The stopping point has been reached, the expansion reversed, and the downward spiral started when the money has "run out". It would be hard to show that any like or analogous condition, or any similar danger of massive credit liquidation, exists today.

Finally, Mr. Clark's analysis seems to underrate the importance of the influences which sustain consumer buying power, including tax reduction, unemployment compensation, pension funds, government aids, farm price supports, and especially the savings to which brief reference has already been made. These influences were effective in preventing the inventory liquidation in 1949 from spiraling downward. In the face of falling sales, production, and employment, consumers drew on these aids, on their savings, and on their credit to sustain consumption; and in due course business buying had to recover to the level of consumption. It has been argued that there were more latent demands in

1949 than now, that consumers have really become satisfied at last. Perhaps it is true that consumers do not want more 1953 versions of houses, cars, appliances, or even packaged foods, than they bought in 1953. But this is no final answer.

A Dynamic Economy

The foregoing interpretation of current business forces, which sees much less downward push and considerably stronger supporting influences than is implied in Mr. Clark's analysis, supplies one answer to his thesis. More fundamentally, it can be argued that he underrates also the dynamic qualities in the American economy.

Rigid mathematical analysis, dealing only in large aggregates of supply and demand, invariably tends to see the economy as more static, impersonal, and mechanistic than it actually is. It forecasts by adding and subtracting changes in demand as the forecasters foresee them. When it finds a mathematical "gap" between demand and supply it prescribes, almost by definition, larger government deficits to fill the gap. In this Mr. Clark is no exception. It tends to belittle or ignore the possibility that the wants of people can fill the gap, provided they are offered goods and services they desire at prices they can pay, and provided that everyone engaged in production and distribution will cooperate to achieve that result. Hence it gives inadequate consideration to the variability of human behavior, to cost and price relationships, to productivity trends, to management decisions and to numberless other influences which cannot be embraced in mathematical equations but which powerfully affect the course of business.

Rigid mathematical analysis, because it is mechanistic, also tends to underestimate the influence of innovation and technological advance. According to recent estimates, the nation is now spending nearly $4 billion a year on research. Technological progress is steadier and more rapid than ever before. The incentive to embody technological developments into industrial practice is always strong; for the manufacturer who is laggard in keeping machinery, methods and products up to date will soon find himself out of the competitive race due to excessive labor costs per unit of product. This is the real driving force behind the huge investment in plant and equipment by American corporations.

It cannot be assumed that the process of innovation and technological improvement will stop because business moves into a period of inventory tightening. Although aggregate sales or orders decline, companies with improved products and lower costs will continue to move ahead. Success of management in meeting these problems tends to stop a downward spiral.

In many other postwar years there have been foreseeable gaps in demand and fears of a spiraling decline. But the gaps have been filled, and the threatened spiral has been averted or arrested. Postwar forecasting has, in fact, been an extraordinary chronicle of unwarranted pessimism. This does not mean that sheer optimism and complacence can make 1954 a year of further growth. On the contrary, it promises to be a year of adjustment, stiff competition, and moderate recession as compared with 1953. It is plain, however, that the predominant sentiment of this country has little fear of such grave developments as Mr. Clark expects, and sees little support for his argument.

New FRB Production Index

Last month the Federal Reserve Board announced the long-awaited revision of its index of industrial production in the U.S. This index, which measures monthly changes in the physical output of factories and mines, has become one of the most widely-used indicators of business trends; hence alterations in it are of importance to business men and others interested in following industrial developments.

The purpose of the revision, which applies mainly to the period from 1947 to date, is to take account of more comprehensive information made available during the postwar period. This includes additional data for new industry groups such as electronics and plastics, as well as adjustments to changes in the structure and pattern of output since the last general revision of this index in 1940 and the wartime revisions in 1941 and 1943. Thus it should provide a better tool for measuring changes in the nation's industrial activity.

Following are the major changes in the revised index:

1. The base period is now the average of the years 1947-49 taken as 100, instead of 1935-39 as heretofore. This is not to imply that activity in the new base period was "normal" or ideal; the change simply brings the new base more up to date, facilitates comparison with other indexes having the same base period, and eases the task of including newer industries such as television.

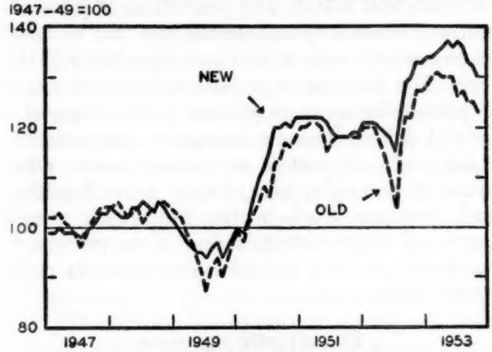
2. The number of monthly series included has been increased, thus making the index more representative.

3. More measurements are in terms of physical units — tons, vehicles, yardage, etc. — with less reliance on such indirect measures as manhours worked.

4. New weights and industry classifications are used, and new seasonal adjustments worked out — the latter taking account of such new influences as the summer drop in output caused by the growing practice of summer vacations in many industries.

Old and New Indexes Compared

The effect of the revisions in the index since 1947 may be seen in the accompanying chart.

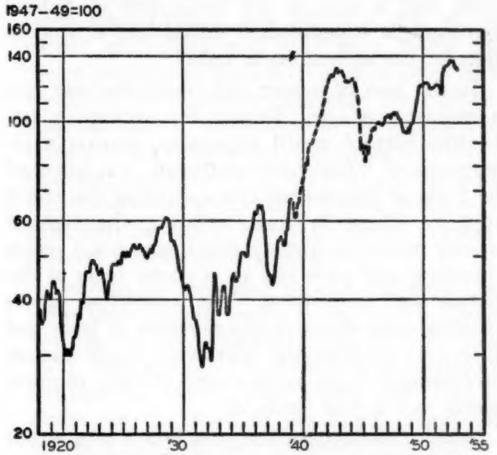


Comparison of Old and New FRB Index of Industrial Production Average 1947–49=100

In broad outline, the two indexes trace a similar course, though closer inspection reveals significant differences. For one thing, the new index appears as a somewhat smoother curve, due partly to the inclusion of data for more industries some of which are of the stabler kind; also the adjustment of seasonals to allow for summer vacations has cushioned the midyear dips, particularly in 1949, '51, and '52.

In 1948, the decline in the new index began earlier, but it bottomed out at a higher level in 1949. Whereas the old index dropped 15 per cent in 1948-49, the new index dropped only 10 per cent. The new index shows a steeper recovery in 1950 — even before Korea — thereafter holding more of a plateau until the upsurge of production in 1952 after the steel strike. The latter rise is now seen to have carried to a substantially higher level last winter and spring than previously indicated. Both indexes show a general decline in production from the 1953 peaks. For November the new index was down 5 per cent from the highs established in May and July, while the old index was down 6 per cent from its high reached in March.

Especially noteworthy is the greater growth of postwar production revealed by the new index. From early 1947 to early '53 the new index rises 35 per cent, as against 27 per cent for the old. Moreover, the new index shows that industrial production exceeded the World War II peak by the latter part of 1952, as indicated in the chart below, whereas the postwar peak of the old index, reached early in '53, was still below the peak of late 1943.



Long-term Trend of FRB Index of Industrial Production, Average 1947–49=100. World War II Period Shown by Dashed Line Pending More Extended Review of War Production Figures.

Long-term Growth of U.S. Production

The above chart is of interest also in giving a perspective of the long-range growth of American industry. It shows that over the 35-year span covered by the index since 1919 production has more than trebled.

This remarkable growth has not been without its interruptions, as the chart clearly brings out. These range in magnitude from the great depression of the early '30s to minor corrections, such as the recessions of 1923-24, of 1948-49, and the smaller dip of 1927. The table indicates the extent of decline registered by the index during various periods of business readjustment over more than three decades.

Declines in FRB Production Index
1947—49=100

Period	Months	High	Low	% Change
Feb. '20 - Mar. '21	13	44	30	—32
May '23 - July '24	14	49	40	—18
Oct. '26 - Nov. '27	13	53	49	— 8
Aug. '29 - July '32	35	61	28	—54
July '37 - May '38	10	65	43	—34
Nov. '43 - Feb. '46	27	132	81	—39
Oct. '48 - July '49	9	105	94	—10
July '53 - Nov. '53*	4	137	130*	— 5

*Preliminary, latest reported.

The significant thing is that always these declines have been followed by recovery and new growth. The challenge of the future is to preserve the dynamic forces that have promoted

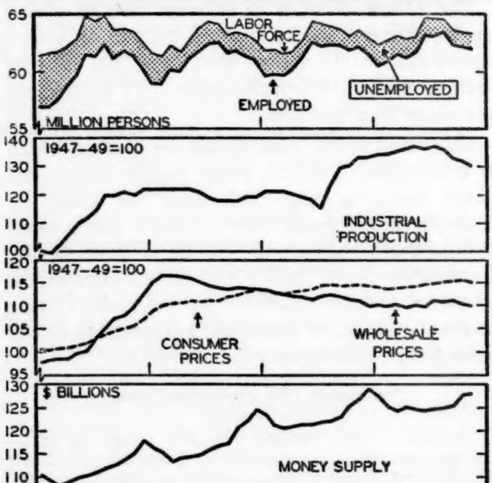
this growth, while at the same time striving to moderate the extreme swings which have such painful consequences.

Credit Policy

The year 1953 saw the installation of a new Administration in Washington, truce in the three-year Korean War, the end of price and wage controls, and a turn in the rising tide of federal government expenditures which laid a foundation for tax reductions in 1954.

In the area of money and credit the year was a momentous one. During the spring an unhealthy rate of credit expansion, stirring a resurgence of inflationary sentiment, was opposed by Federal Reserve policies restricting the credit supply. These in turn, creating the tightest money market in twenty years, sent bond prices tumbling and gave rise to opposite fears of deflation and depression. The restrictive credit policies were dramatically reversed in June and July, and creditworthy borrowers found lenders increasingly eager to take care of their requirements as the year wore on.

Amid these events, the year was a prosperous one by the accepted standards of production, employment opportunities, and income levels. The accompanying chart gives the figures since 1950 for labor force and employment, industrial production, consumer goods and wholesale prices, money supply, and bank loans.



Total Civilian Labor Force, Employed and Unemployed; Industrial Production; Wholesale and Consumer Prices; Money Supply (currency outside banks and adjusted demand deposits); Commercial Bank Loans.

In the background of the years of spiraling inflation, the stability of commodity prices was of special significance. Measured by the broad indexes, prices held steadier during 1953 than in any of the preceding seven years. During the year the maximum change from the December, 1952 level of wholesale prices never exceeded 1½ per cent; the same held true of consumer prices.

This price record was all the more remarkable since price and wage controls were removed in February and March. The predictions of price administrators that prices would rise out of hand when controls were ended had plausibility at the time. The familiar ingredients of another round of price inflation were present in the shape of a federal deficit, business inventory accumulation, rapid credit expansion, an incompressible minimum of unemployment, heavy order backlogs and overtime work in the industries, a new round of wage demands and a temptation to employers to give in and raise prices to make up for higher costs.

The Credit Squeeze

Other forces, including self-restraint among businessmen, enlarged flows of imports at lower prices, and cuts in government spending programs, contributed to the record of price stability. But there can be little question but that the spring credit squeeze, acting to chill inflationary sentiment, had the most immediate and direct effect of steadying out prices. The squeeze developed out of the weight of credit demands, including the deficit-financing requirements of the Treasury. It was made effective by a Federal Reserve policy of asking banks to pay down their borrowings — a policy that demanded a slow-down in lending and the sale of bonds on a falling market.

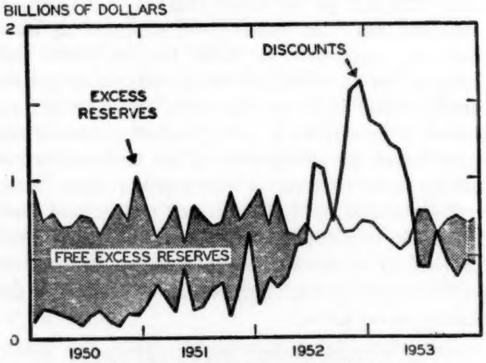
The falling bond market in turn attracted investment funds from the mortgage market, tending to check the upsurge of building activity. Corporations, States and municipalities tended to rush ahead with planned bond offerings in fear of even greater stringency later in the year, but they also had reason to review their requirements and capital expansion plans.

It stands as evidence of the basic strength of the economy, the longer view optimism of businessmen, and the quickness of the Federal Reserve policy reversal that the reaction from the credit squeeze was not greater. Tendencies toward inventory liquidation appeared and slowed

the demand for bank loans but no broad deflation of loans or money supply set in. Corporate bond flotations, which had been heavy in the second quarter of the year, slowed sharply in the third quarter but accelerated again in the fourth. Industrial production declined moderately along with a reduction in overtime work and some retirements from the labor force of people not ordinarily employed. Unemployment levels, however, remained subnormal through November, the last month for which figures are available. Consumer incomes and outlays — also construction activity in total — made record levels for the year as a whole.

Reversal of Policy

The change-about in Federal Reserve policy is reflected in the second chart which shows the excess reserves and borrowings of the member banks. The Federal Reserve began to give a little ground on its restrictive policy in April and May, buying $440 million in government securities. The effective change occurred in June and July when a further $718 million government securities were purchased and cash reserve requirements of the member banks were lowered $1150 million. These actions, along with slackened credit demands, built up excess reserves and enabled banks to pay down borrowings. Further purchases from August through December 29, totalling $1525 million, covered the drain on bank cash from the seasonal increase in currency circulation and left the banks well supplied with funds to meet loan demands.



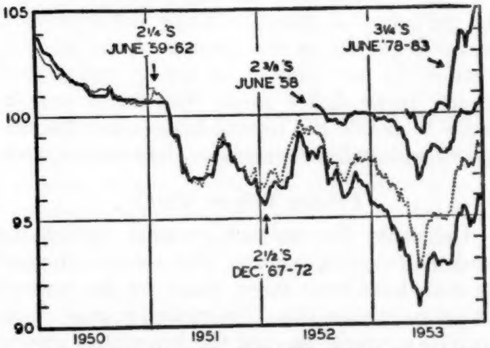
Member Bank Excess Reserves and Discounts
(Monthly averages of daily figures)

Open market money rates responded rapidly to the change in policy. The cost of money to the Treasury on sales of 91-day Treasury bills, which averaged 2.20 per cent during the second quarter, averaged 1.48 per cent during the final quarter. The rate on prime 4-6 months' commercial paper, which had moved up from 2¼ to 2¾ per cent, went back to 2¼ per cent. The rate paid by the Treasury for one-year money went from 2¼ per cent in February to 2⅝ per cent during the summer, and then down to 1⅞ per cent — as low as this rate has been since the bond market was unpegged in March, 1951.

Bond Market

The bond market, entirely demoralized in June, turned the corner when hesitant buyers came forward and new offerings fell off, and gained confidence and absorptive power from the re-entrance of bank buying stimulated by the easing of their reserve positions, the failure of loan demands to materialize in the expected volume, and the sharply reduced yields on Treasury bills and certificates. In the final quarter of the year the Treasury shifted $4 billion of the public debt into five- and eight-year bonds, at rates of 2½ and 2¾ per cent respectively.

Despite the increased supply, Treasury bonds made their highest prices of the year in December. As the chart below shows, the 3¼s due in 1983, which slipped to 98½ a few weeks after issuance on May 1, rose above 105. This premium cut the yield to the buyer considerably below 3 per cent and indicated possibilities of putting out bonds beyond twenty years to maturity at a 3 per cent rate. Save under special market conditions, such as when pegs were in force protecting the buyer from loss, or when government bonds carried a privilege of securing national bank note issues, three per cent is the cheapest the Treasury has ever been able to borrow long-term money.



Friday Closing Bid Prices, Selected U.S. Government Bonds
(Last plotting for Thursday, December 24)

The average yield on high-grade State and local government bonds, which moved from 2 per cent in April 1952 to 3⅛ per cent in June 1953, settled around 2⅝ per cent in December. New issues of this class, valued by the investor for their exemption from income tax, reached a record volume approximating $5 billion. Yields on highest grade corporate bonds, as measured by

Moody's Aaa average, rose from 3 per cent at the beginning of the year beyond 3⅜ per cent in June and then declined irregularly to 3⅛ per cent. The volume of new corporate bond issues, after a comparatively low third quarter, recovered toward the year-end to produce an annual total closely approaching the $7½ billion record of 1952.

Controversy Over Policy

In his Message to Congress on the State of the Union last February, President Eisenhower set out, as immediate tasks, checking the menace of inflation while maintaining economic stability and encouraging "the free play of our people's genius for individual initiative." The chosen means for accomplishing these wholesome objectives were curtailing planned government expenditures, improving the structure of the public debt, freeing the Federal Reserve to make credit cheap or dear as the economic situation might dictate, discarding wage and price controls, and easing the tax burden.

This program has been carried forward. The moves taken in the areas of credit and debt management stirred vehement objections, reviewed in the September issue of this Letter. The Federal Reserve was attacked for unduly retarding the growth of the money supply and depriving the Treasury, home builders, and business of adequate access to credit. In Congress the Treasury, for paying 3¼ per cent on its initial offering of long-term bonds, was accused of adopting policies of raising interest rates for the special benefit of banks and insurance companies and to the injury of debtors. Trade union publications, neglectful of the interest of the laboring man in the real value of his savings and pension rights, spoke darkly about Wall Street conspiracies to saddle the federal budget and the taxpayer with radically increased debt service costs.

Critics Taken Aback

Critics of the policies pursued during the spring, including bankers who raised voices of protest, have been taken aback by the reversal of policy in June-July. The central feature of the year as a whole was not the increase of money rates and bond yields but the widened range of fluctuations. Money rates — after having been held down as a matter of arbitrary government policy for so many years — have been working their way up to more normal levels ever since the war. However, the rise in the average interest cost on the public debt during 1953 was only six hundredths of one per cent — from 2.35 to 2.41 per cent. This is a modest price to pay for a stable dollar. It is less than the increases in a number of other postwar years.

Within the financial community, the spring money pinch was more of a lesson than an opportunity for profit. The most lasting financial benefits may go to pension funds which evidently were the biggest buyers of the Treasury 3¼ per cent bonds. Insurance companies gained from improved yields on new investments though at the expense of market price depreciation on bonds previously acquired. Banks found their deposits and available loan funds shrinking; their security holdings saleable only at a loss. While bank loan rates rose, so also did rates offered and paid to attract savings deposits.

What the experience had to teach borrowers as well as lenders and investors was the value of perspective, timing, spacing of maturities, and attention to the fundamentals of credit supply and demand. It taught the usefulness of anticipating borrowing requirements when market conditions are favorable and of being prepared to wait when they are adverse. If, as many hold, the authorities made mistakes in letting money get too tight in the spring and too easy in the fall, they may repeat mistakes. The market's task is to be prepared for eventualities never clearly foreseeable, and to adjust to developments as they occur.

Inflationary Policy Adopted?

There is, to be sure, a view heard that the lesson of 1953 was not for the market but for the Administration and the Federal Reserve System. The fall in the bond market, the storm of criticism, and the subsequent slippage in business are supposed to have taught them that cheap money is necessary to the easy and orderly management of the public debt and that the inflation it generates is a tonic that provides the sure means to prosperity. The authorities are said to have discovered that sound money, however desirable in theory, is not a practical goal. Thus, the implication is, there is no great need for lenders or borrowers to concern themselves with a repetition of tight money or sharply declining bond prices.

This view gains plausibility from the extent to which the Federal Reserve has gone to increase the supply of loan funds in a time of booming prosperity. Certainly, with the $73 billion public debt maturities the Treasury faces in 1954, the temptation will be present to keep money cheap as an aid to Treasury finance.

On the other hand, this interpretation has an uncomfortably close resemblance to the theory widely accepted for years that U.S. Government

bonds simply *couldn't* be allowed to trade below par because it would make undue difficulties for Treasury finance. Similarly a year ago there were skeptics who, for the same reason, refused to accept at face value official statements that steps would be taken to defend the dollar, lengthen out the public debt, and use credit policy flexibly in the interests of economic stability. The argument again was that these objectives were impractical. But practical difficulties did not deter effective action. By now everyone should be on notice to expect two-way fluctuations in bond prices and money rates.

The broad record of the Administration is performance upon the promise – including the promise to defend the dollar. And no Administration should relish rebuilding an artificial money market and reopening the controversy over cheap and depreciating money that reached its climax in the unpegging of the bond market in March, 1951. Sound money, as then became apparent, has a broad public support.

Place of Flexible Credit Policies

In a free society people cannot be led by the nose. Economic stability has to be achieved, if it is achieved at all, by stability of consumer and business spending supported by appropriate and flexible fiscal and credit policies. Previous to 1953 tax increases were the favored guard against inflation. Heavy government spending and cheap credit gave protection against deflation – or, rather, as proved to be the case, insured that inflation would prevail in spite of the heaviest load of taxes the American people have ever been called upon to carry.

The present direction of public policy is to curtail government spending and to improve the debt structure, bringing tax relief into play as a stimulating force on private spending and initiative. Credit policy – eight months ago on the side of restraint – is working today as a stimulant to spending. It is safe to say that it will have to work on both sides, alternately, in the years ahead if we are to keep on anything like an even keel.

Social Security Tax Increase

On January 1, 1954 the rate of the social security tax for Federal Old-Age and Survivors Insurance, in accordance with existing law, rose automatically from 1½ to 2 per cent, payable by both employes and employers on earnings up to $3,600. Although the Administration had recommended last spring that the rate in effect since 1950 be "frozen" for another year, Congress took no action to postpone the statutory rise.

Whether the increase should have been allowed to go into effect is a complex question. It may be forced before the new session of Congress for reconsideration, even though rescinding the increase would involve the formidable task of readjusting the payroll records of 47,000,000 persons whose taxes are being withheld or remitted directly.

President Eisenhower recommended that the scheduled rise in the tax be postponed on the grounds that receipts at the then prevailing rate were in excess of current expenditures and that the trust fund had reached $18 billion. He added, "This will be a worthwhile saving to wage-earners and, in my judgment, is simple justice to them. . . . From now on, the old-age tax and trust accounts, while maintaining the contributory principle, should be handled more nearly on a pay-as-you-go basis."

Since the beginning of the federal social security system in 1937 the growth in annual receipts, expenditures, and the trust fund is summarized in the table:

Federal Old Age & Survivors Insurance Trust Fund

(In Millions of Dollars)

Year June 30	Receipts	Expenditures	Year-end Assets
1937	$ 267	$ —	$ 267
1938	515	5	777
1939	417	14	1,180
1940	592	28	1,745
1941	744	91	2,398
1942	967	137	3,227
1943	1,218	177	4,268
1944	1,395	217	5,446
1945	1,434	267	6,613
1946	1,386	358	7,641
1947	1,623	466	8,798
1948	1,807	559	10,047
1949	1,924	661	11,310
1950	2,367	784	12,893
1951	3,412	1,569	14,736
1952	3,932	2,067	16,600
1953	4,516	2,750	18,366
1954*	5,000	3,200	20.200

Includes, prior to 1940, transactions under the prior Old Age Reserve Account. *Budget estimate.

In the fiscal year ended June 30, 1953 receipts from taxes on employees and employers, plus $387 million interest on investments, amounted to approximately $4.5 billion; expenditures for benefit payments to workers retiring at age 65, their survivors, children, etc., plus administrative expenses, were $2.7 billion; and trust fund assets, invested largely in special issues of U.S. Government securities, totaled $18.4 billion at the year-end. For the current fiscal year the latest budget estimates indicate increases in receipts to around $5.0 billion, in expenditures to $3.2 billion, and in the trust fund to $20.2 billion.

Early Modifications of Insurance Plan

Originally the tax started at 1 per cent each on employe and employer up to the first $3,000

of payroll. It was scheduled to rise by ½ of 1 per cent every three years to a maximum of 3 per cent by January 1, 1949. Such increases, however, were postponed by Congress repeatedly, until the amendments effective January 1, 1950 which stepped up the rate from 1 to 1½ per cent. Effective one year later, the amount of earnings subject to the tax was raised from $3,000 to $3,600.

The original plan contemplated that the substantial excess of tax collections over benefit payments each year would be set aside in a trust fund. This was estimated to reach approximately $47 billion by 1980 and to represent a "reserve" against the accumulating liability. In the amendments, however, adopted after some years of actual experience in the operation of the system, the principle of building up a "full reserve", to cover the total liability computed by usual actuarial standards, was given up in favor of a "contingency reserve", of only three times the prospective annual distributions.

Thus the concept of social security has shifted from a system where, as in insurance company operation, reserve funds are accumulated adequate to meet fully the eventual liabilities, to a system where a substantial portion of the benefit payments, as they become due, is paid out of current tax collections. To this extent the system therefore has moved toward a pay-as-you-go basis, where the current social security contributions are collected as any other tax and the current social security benefits are paid as any other government expenditure.

For large numbers of people who pay little or no income taxes the effect of the social security tax step-up on January 1, 1954 is to bring an increase in the overall tax despite the 10 per cent cut in the income tax effective on the same date. Any overall tax increases, however, are extremely modest, since in no case does the social security tax go up more than $18 a year, or 35 cents a week, regardless of how much the taxpayer makes.

Opinion in Congress on the social security tax increase is sharply divided and cuts across party lines. Chairman Reed of the House Ways and Means Committee has opposed a tax freeze, urging that the contributory principle of the program be maintained and strengthened. He declared:

> I believe that the American people want social security and are willing to pay for it. While I strongly favor tax reduction and believe that the people are entitled to a larger reduction than that now scheduled, I do not believe that such a tax cut should be achieved at the expense of a sound social security system.

Taking the opposite view, other Republicans, including Speaker of the House Martin, and various Democratic members of Congress, including Senator George, ranking minority member of the Senate Finance Committee, have indicated their support for freezing the tax.

Case for the Tax Increase

On behalf of the tax increase it is argued that additional receipts are needed to build the reserve fund to where it will more nearly provide for the upward curve of benefit payments projected for the future.

This, in essence, is the argument implied by Congressman Reed when he rejects a tax cut achieved "at the expense of a sound social security system." Involved here is the basic question, to which we revert later, as to whether the plan of building a huge reserve fund of government securities actually does provide any greater assurance of protection to old-age pensioners than a pay-as-you-go plan.

A second point for letting the tax rise and strengthening the contributory principle is in keeping alive in the public mind the idea of linking social security costs and benefits, so that people feel they are providing for their own old age protection and not getting something for nothing. This is particularly important at a time when proposals are afoot to liberalize benefits.

A third argument for upping the tax is that the Treasury is in no position to forego the $1.2 billion additional receipts annually the tax hike would bring in from employers and employes combined. To be sure, social security taxes are not included in the regular or administrative budget; nevertheless they are part of the cash intake of the Treasury and hence available to meet cash outlays.

Still a fourth argument sometimes advanced is that social security taxes are not really taxes at all, but insurance premiums — analogous to those of private insurance companies which have always been looked upon as a form of saving. A rise in the social security tax, according to this theory, should not be regarded as a tax increase but rather as an increase in saving.

Case Against the Tax Increase

Turning to the opposing case, a first point relates to the basic question raised above, viz., whether the piling up of great quantities of its own debt securities as a "reserve" does, in fact, add anything to the ability of the Government to meet social security obligations.

The answer to this question must be that it does not, as was brought out in testimony by Social Security Chief Actuary Robert J. Myers and Robert M. Ball, Acting Director of the Bureau of Old Age and Survivors Insurance, before the Ways and Means subcommittee on social security last November. Following are the pertinent passages, as reported in the press:

Mr. Myers declared that none of the $21.8 billion in the trust fund paid since the start of the system by the 87.7 million persons, not on the benefit rolls and still working, and their employers, will be available for benefits to them when they retire.

All persons in this group will be dependent on future taxes paid into the system, they said.

Money collected in social security taxes is not held as idle cash in the Treasury where it can be paid out in social security benefits when people retire. It is invested in government securities issued to the trust fund by the Treasury, and the money itself expended for general budgetary purposes just as are the proceeds of any other Treasury borrowing. At the same time the securities held in the fund serve as earning assets, the income of which is to pay retirement benefits as they fall due. Thus money to meet these interest payments and retirement benefits must be provided by taxes at the time these liabilities mature. In the final analysis, future pension payments, whether financed by an accumulated reserve of government securities or under a pay-as-you-go plan, can only be made out of taxes on income of the future.

For the Government to hold the vast sums collected in social security taxes idle and uninvested would of course be wholly impractical and insupportable from every angle. The above point, however, raises a question as to the wisdom and necessity of increasing taxes to build up a huge reserve fund in advance of actual needs. For this and other reasons, the National Association of Manufacturers and the U.S. Chamber of Commerce have urged abandonment of the reserve fund principle — already watered down by various amendments from a full reserve to a contingency reserve basis — in favor of some form of pay-as-you-go.

The argument seems doubtful that the trust fund arrangement strengthens the Government's moral commitment to make the promised benefit payments when they fall due more than does pay-as-you-go. The fact is that under either plan Congress would always have power to change the terms, but that it would actually do so to the detriment of the pensioners appears most unlikely. Political pressures being what they are, the tendencies are all the other way.

That the Treasury needs the money that will come from a higher social security tax to help cover current cash outlays cannot be denied; but consideration must be given to how a rise in the tax now fits into the general budgetary picture and trends in the economy at large. With the former conditions of full employment and price inflation giving way to some slackening of activity and softening of prices, both the Administration and Congress have consciously accepted the desirability of a national budget and economic policy granting some measure of tax relief to both individuals and business. In such circumstances, an actual tax increase — whether labelled as such or as increased insurance premiums payable under a scheme of forced saving — seems hardly consistent. Apart from the question of the appropriateness of such action to the general state of the economy, there is a question of equity involved when some people — all in the lowest income brackets — have to pay more through higher payroll taxes even though the amount of such increase is small.

Timing of Tax Increases

In short, what the debate over the social security tax finally comes down to is partly a question of moving further towards a pay-as-you-go basis as the President has advocated, and partly a question of the timing of tax increases. As to the latter, it is perfectly possible to accept the proposition that a step-up in the social security tax is desirable, but still postpone the effective date of such increase for, say, another year when the general economic situation might be more propitious. This is particularly true since no one can know with any degree of accuracy how large the social security reserve, if any, should be — there being so many indeterminable factors involving population, mortality, covered employment, family composition, and interest rates affecting the long-term trends.

Also on this matter of timing, there is the further point that Congress is expected to undertake a thorough-going overhauling of the whole social security program this year. Thus there is much to be said for keeping the payroll tax unchanged until it is possible to see what comes out of the hopper.

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